



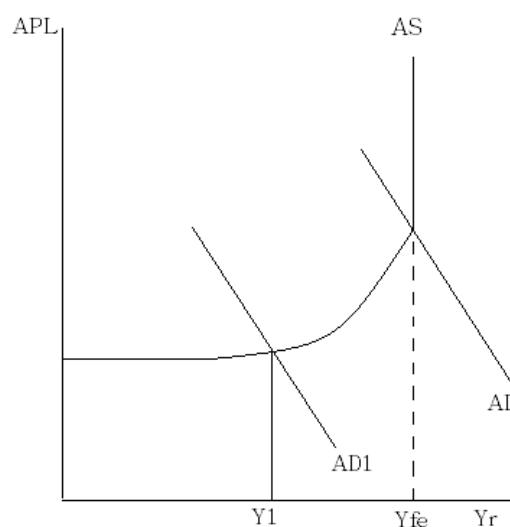
11 o'clock files

Simply Gaps and Adjustments

The Keynesian Take

The Deflationary Gap within the Keynesian diagram

- Assume that aggregate demand decreases to AD_1 from AD because of, say, a collapse of consumer and business confidence
- Equilibrium real output will decrease to Y_1
- Equilibrium real output Y_1 is now below the full employment level of real output Y_{fe} .
- There is a deflationary (aka recessionary) gap equal to Y_1Y_{fe} .



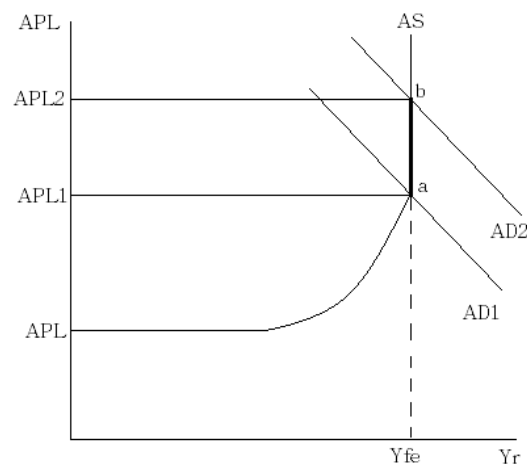
Will the economy return on its own back to full employment?

- According to the Keynesian School, the answer is **no**
- Why not? Because according to the Keynesians, money wages are *sticky downwards*. There is thus no endogenous mechanism to push the economy back to full employment.
- An economy thus may be *stuck in a deflationary gap* i.e. at a level of real output (of economic activity) below full employment (in the Monetarist diagram, the economy may be stuck at point A2)
- Is there any solution?
- Yes, the Government must intervene and try to increase aggregate demand
- How can it do this? By increasing government expenditures (and, lowering taxes) → *deficit spending*; this is known as expansionary fiscal policy (see separate 11 o'clock file);
- Mind you that AD could also increase via looser monetary policy: the Central Bank could lower interest rates (see separate 11 o'clock file)

The Inflationary Gap within the Keynesian diagram

- Assume an economy in equilibrium at its full employment level of real output Y_{fe} and an increase in aggregate demand from AD1 to AD2 because of, say, exuberant consumer and business confidence
- Equilibrium real output will remain to Y_{fe}
- The average price level though will rise from APL1 to APL2.
- The distance ab is referred to as the **inflationary gap**

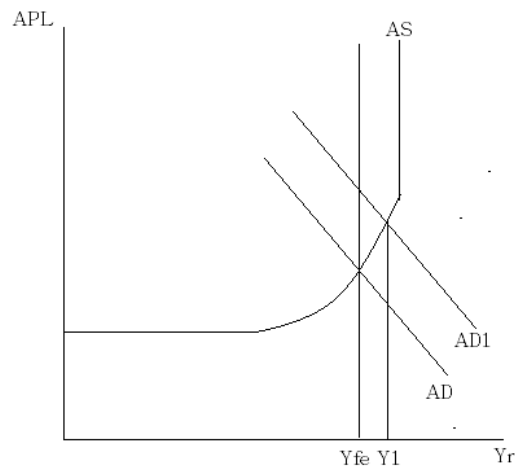
The Keynesian inflationary gap



- Note the **asymmetry** from the Monetarist take: the gap is now on the vertical axis; the reason is that in the (pure) Keynesian model, full employment refers to *no* unemployment → the term 'natural rate of unemployment' was coined by Milton Friedman, perhaps the most prominent monetarist economist.
- If you insist on incorporating the idea of a natural rate of unemployment within the Keynesian model, you could. Note though that it is *not* the way described in the IBO syllabus → you just need to define as the full employment level of real output, some level of output *to the left* of where the vertical section the AS would intersect the horizontal axis.

An alternative take on the Keynesian inflationary gap

(not as described in the syllabus → could ignore)



- Here, the full employment level of output is set to the left of where the vertical section of AS would intersect the horizontal axis → the increase of AD to AD1 creates an inflationary gap equal to distance $Y_{fe}Y_1$ on the horizontal axis